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IN THE

Supreme Court of the United States

OCTOBER TERM, 1944

No. 188.

In the Matter of

ALBERT E. MCKENZIE, as Trustee in Bankruptcy of GRAVES-QUINN CORPORATION,

Petitioner,

—*against*—

IRVING TRUST COMPANY,

Respondent.

ON WRIT OF CERTIORARI TO THE COURT OF APPEALS OF THE STATE OF NEW YORK

REPLY BRIEF FOR PETITIONER

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Before proceeding to reply to the legal arguments advanced by Respondent, we beg leave to point out several important inaccuracies in the statement of facts appearing in the Respondent's brief.

I.

In an obvious effort to belittle the requirements of the Assignment of Claims Act, Respondent states at page 7 of its brief that it obtained the necessary consent as a matter of course, and that the consent was not expressly related to Respondent's assignment. The fact is to the contrary. Exhibit "J" (R. 15) is a memorandum dated December 4, 1940, addressed to the Assistant Secretary of War by the Quartermaster-General. It specifically refers to the assignment in question and recommends its approval by the Assistant Secretary of War. It appears from said exhibit that the assignment in question was attached to the Quartermaster-General's memorandum recommending approval of the assignment. It was upon that recommendation that the approval of December 5th was obtained.

II.

The statement is made that the Quartermaster-General was notified of the assignment and furnished a copy on November 27th. This is erroneous. As appears from Exhibit "F" (R. 12-13) the letter of the Quartermaster-General enclosing the assignment is only dated November 27th. It appears from Exhibit "G" (R. 13) that it was only forwarded on November 27th, and could not conceivably have reached the Quartermaster-General before November 28th.

Until respondent filed the assignment and notified the surety of the assignment it was a secret transfer within the meaning of Section 60a of the Bankruptcy Act.

Fully conscious of the following excerpt from the opinion of this Court in *Corn Exchange National Bank & Trust Co. v. Klauder*, 318 U. S. 434, at 438-9, viz.:

> "The Committee of the House of Representatives which reported §60(a) as quoted above was fully aware of the vicissitudes of its predecessors. These are recited in detail elsewhere, and need not be repeated here beyond a general statement that for thirty-five years Congress has consistently reached out to strike down secret transfers, and the courts have with equal consistency found its efforts faulty or insufficient to that end. Against such a background §60(a) was drawn and reported to Congress with this explanation of its purpose and effect: 'The new test is more comprehensive and accords with the contemplated purpose of striking down secret liens. * * *'"

respondent simulates an almost naive forgetfulness of those provisions of the Assignment of Claims Act that require notice of the assignment to the main potential and actual

creditor—the Surety Company. Respondent concerns itself almost solely with the provisions of the Assignment of Claims Act that deal with filing and consent of the Secretary of War.

It is obvious that the requirement of notice to the surety was placed in the Act in order to make the surety aware of the financial condition of the contractor. For years sureties have written bonds on public constructions, and their legal position as the largest creditor in the event of trouble was well established. While it may well be that the rights of the surety were in no manner changed by the Assignment of Claims Act, Congress, nevertheless, saw fit to require notice to the surety as a prerequisite of any assignment. As the Respondent itself points out (p. 28 Resp. Brief) the sureties at first sought a veto power over any assignment. The requirement of notice was evidently a compromise. The requirement of notice was neither mere verbiage nor accidental, but a vital requirement, in view of the over-all interest of the surety in the performance of the Government contract, and the availability of the Government funds for its completion. It is this essential element that the Respondent completely ignores and neglects in its consideration of both the validity of the assignment and its effectiveness within the meaning of Section 60a of the Bankruptcy Act.

Whatever were the judicial attempts to liberalize the rigors of Section 3477 of the Revised Statutes prior to the amendment of October 9, 1940, Congress made no change in the body of the statute, which clearly stated that the assignment was absolutely null and void. Congress merely appended a rider which stated the express conditions under which the restrictions and penalties attaching to assignments might be lifted.

If the assignment was void before October 9, 1940, certainly it gains no greater validity by reason of the failure to comply with the very requirements which the statute

enumerate to take it out of ~~the realm of nullity.~~ Respon~~dent also blinds~~ itself to the very language of the section when it states that there is nothing in the statute to encourage the notion that the assignment was wholly inoperative pending compliance or any penalty for failure to comply. Nothing, we say, but the very language of the statute, which says the assignment is absolutely null and void, unless, amongst other things, filing was accomplished and notice to the surety given.

The authorities mentioned under Point I of Respondent's brief all deal with situations where assignments may be freely made without the requirements of filing or notice to creditors or where no bankruptcy doctrine was involved as *Pickering* v. *Lomax*, 145 U. S. 310. Thus, *Rockmore* v. *Lehman*, 129 Fed. (2d) 892 (cert. denied 317 U. S. 700) involved assignments of business contracts, and the question before the Court was simply whether the date of the assignment of the contract was the date to be fixed for the running of the four-month period, or whether the date the assignee received the moneys under the assigned contract was the proper date. The Court came to the conclusion that inasmuch as the assignment of the contract was effective as of its date, it mattered not when the moneys were received by the assignee. The decision was predicated wholly upon New York statutes, where no filing or notice to anyone was necessary. The mere citation of that authority, in view of the Federal statute first prohibiting assignments and then quaiifying their validity under certain conditions, but shows the confusion with which Respondent approaches the legal matters under consideration.

Respondent argues that secrecy does not preclude perfection of a transfer otherwise permissible. Nobody disputes that, but where a statute not only demands filing, but notice to the largest potential creditor, secrecy in itself precludes

the perfection of the transfer within the meaning of Section 60a, because that was the very circumstance at which Section 60a was directed.

Respondent's argument that the purpose of the Assignment of Claims Act can best be served if lending institutions can rely on it is a misdirected one. All that lending institutions need do is to comply with the Act and then they may rely on it without question. It is idle to urge, as Respondent does, that the four or five days which may be needed to obtain consent and give the requisite notices in any way constitutes a hardship or a deterrent to institutions making loans. It is only in instances of the present kind, where institutions seek these assignments to secretly bail themselves out of precarious positions, that speed becomes so urgent, but that is the very thing which Section 60a is directed against. If any contractor is so strapped for funds that he cannot make his arrangements sufficiently in advance to await financing until four or five days elapse, then, we say, he deserves no financing.

Certainly banks know that sureties are the real parties in interest. If they choose to advance monies without notice to the very party that is responsible to the Government for completion, when the statute requires such notice, banks should suffer the consequences. No bank is under any obligation to loan monies with or without the collateral assignment. In fact the loans in the instant case were made before the assignment was even executed. Respondent obtained the assignment not to finance, but to grab the money and then close down on the bankrupt. That is most evident from the Respondent's own office memoranda (R. 33, 37).

The mailing of the check did not pass title to Respondent.

Respondent cites a number of cases at pages 36 to 41 of its brief to the effect that the mailing of the Government check on November 27th constituted delivery and transfer of title thereto to the bank. Here, again, Respondent entirely overlooks the fact that the check was mailed for deposit only. The authorities cited by Respondent merely concern themselves with delivery where there was an intention to pass title to an endorsee or assignee. What is required to pass title to a check where there is an intention to pass title is wholly irrelevant to the question as to whether a bank acquires title to a check where it is transmitted for the purposes of deposit only.

Thus, in one of the cases cited by respondent, *Chapman v. Mills & Gibbs*, 241 Fed. 715, the check was endorsed to the order of the bank and *not mailed for deposit* as it was in the case at bar.

Respondent completely overlooks the fact that the mailing by a depositor of a check for deposit passes no title to the check, and that it is but a limited endorsement.

Section 35 of the New York Negotiable Instruments Law specifically states that:

> "Every contract on a negotiable instrument is incomplete and revocable until delivery of the instrument for the purpose of giving effect thereto. As between immediate parties, and as regards a remote party other than a holder in due course, the delivery, in order to be effectual, must be made either by or under the authority of the party making, drawing, accepting or indorsing, as the case may be; and in such case the delivery may be shown to have been conditional, or for a special purpose only, and not for the purpose of transferring the property in the instrument."

Section 350-c of the Negotiable Instruments Law distinctly provides as follows:

> "An indorsement of an item by the payee or other depositor "for deposit" shall be deemed a restrictive indorsement and indicate that the indorsee bank is an agent for collection and not owner of the item."

The Court of Appeals in *Soma v. Handrulis*, 277 N. Y. 223, stated at pages 231, 232:

> "The indorsement by the payee 'for deposit' was not an indorsement in blank. The check was not thereby negotiable in the hands of any person to whom it might come (2 Bouvier's Law Dictionary (Rawle's Third Revision, 8th ed.), p. 1545). It was not payable to bearer, could not be negotiated by delivery, and no title was transferred to any one. It still remained, at least until it was paid, the property of the plaintiff (Bank of Clarke County v. Gilman, 81 Hun, 486; affd., 152 N. Y. 634). The indorsement was restrictive and prohibited further negotiation for any purpose except for collection for deposit in her account."

It is significant that the Court of Appeals in its opinion did not base its decision on the respondent's present argument that title to the Government check passed on mailing. The Court of Appeals could not have conceivably made any such ruling in view of the foregoing statutory restrictions and authority.

What the Court did say was (R. 77):

> "Certainly when the contractor received payment by check from the government on November 27th it was in good faith bound to deliver the check or its proceeds

to the defendant in accordance with its agreement as evidenced by the executed assignment" (R. 77).

That alleged duty is the very question at issue.

The Court of Appeals predicated the duty on the assignment. It is the validity of that very assignment that is in issue. Therefore respondent's discourse on the rights obtained by the mere mailing of the check and the alleged passage of title not only formed no basis of the opinion of the Court of Appeals but is entirely irrelevant.

The New York law as to the rights of successive assignees does not govern the disposition of this case.

A large part of Respondent's brief concerns itself with the argument that the law of New York is to the effect that where there are two successive assignments, the first has priority.

We have, of course, pointed out in our main brief that New York law is inapplicable where we deal with Government funds regulated by Federal Statute. The fact that the Court of Appeals of the State of New York itself recognized that principle in the case of *Manhattan Commercial Co.* v. *Paul*, 216 N. Y. 481, is entirely ignored by Respondent.

It may also be well to point out in this connection that the Personal Property Law of the State of New York requires the application of the Federal Act. Section 41 of the Personal Property Law of the State of New York provides as follows:

"Sec. 41. Transfer of Claims.—

1. Any claim or demand can be transferred, except in one of the following cases:

* * * * *

(3) Where a transfer thereof is expressly forbidden by a statute of the state, or of the United States, or would contravene public policy."

Respondent's error becomes more apparent when we consider that even in New York State, where moneys on a public construction are involved, the rights of an assignee are governed by the Lien Law, and not by the General Law pertaining to simple assignments. *Lee* v. *Bailey*, 267 N. Y. 161.

It would be an entirely different matter if Federal statutes did not require filing, and if Federal funds were not directly involved and their disbursement regulated by Federal statute. Even where both Federal and State statutes provide for filing or recording, the Federal statute will govern and supersede the State requirement where it particularly affects something over which the Federal Law has jurisdiction.

In the Matter of National Fish Co.; 6 Am. Bank. Reports (N. S.) 454.

In this connection, Respondent's comment on *Judson* v. *Corcoran*, 58 U. S. (17 Howard) 612, is characteristic. In that case this Court held that a second assignee of funds in the hands of the Government, and who notified the proper authorities of the assignment and obtained an award after a hearing, had a right to the fund as against a first assignee who failed to give notice, where notice was permissive only. Respondent now, with every appearance of indignation, suggests that it is irrelevant to the realities of this case as to how the Respondent might fare in a contest with a subsequent assignee in possession of the subject matter of the assignment. Yet the Respondent concedes (p. 14 of its brief) that one important aspect on which the effectiveness of its assignment depends is, "Was the assignment operative as against a subsequent assignee."

The Respondent Has No Right of Set-off.

In spite of the fact that the instant motion was made on the sole ground that the transfer complained of was without the four month period and in spite of the fact that respondent itself admits at pages 9 to 10 of its brief that the aforesaid was the sole ground of the motion, the respondent now urges that it was entitled to the Government check by way of set-off.

The principles applicable to the right of set-off have been so clearly enunciated by the Courts that it is inconceivable how, under the present circumstances, respondent could have even suggested that right. It is well established that a set-off can only be invoked where there was no prior thought of applying the deposit to repayment of the loan. It is clear from all the affidavits, and, as a matter of fact, the bank urges throughout its brief that the deposit of the Government check, as well as the bankrupt's check, to the order of the respondent for $150,000, was made with the express intent of wiping out the indebtedness of the bankrupt to the respondent bank.

We need go no further than the bank's own memorandum of November 28th, wherein the decision was arrived at that upon receipt of the check the bank's indebtedness should be repaid and no further advance made (R. 33).

The rule is clearly stated in *Goldstein v. Franklin Square National Bank* (C. C. A. 2d Cir.), 107 F. (2d) 393, wherein the Court said at page 394:

> "The cause of action alleged against the bank was that deposits made by the bankrupt between December 15th and December 27th, although made in his checking account, were intended to be used and were in fact used to pay off an antecedent debt of $1,000 owed by the bankrupt to the bank, this at a time when the bankrupt was insolvent, within four months of bankruptcy, and

when the bank had knowledge or reasonable cause to believe that payment of the debt would give it a preference over other creditors. If these allegations were true, the deposits were voidable preferences under section 60 of the Bankruptcy Act. Deposits accepted by a bank with intent to apply them on a pre-existing claim against the depositor rather than to hold them subject to the depositor's checks in ordinary course are given their intended effect when so applied, that is to say, they are payments on account of the debt; and if they were made when the depositor was insolvent and within four months of bankruptcy, with knowledge or reasonable cause to believe on the bank's part that the depositor was insolvent, they are recoverable by a trustee in bankruptcy as voidable preferences. (Citing cases.)"

There is another compelling reason why the right of set-off does not exist in this case. It has been repeatedly held that where a bank knows that the deposits are, in fact, trust funds, no set-off can exist. There is no question in this case but that the respondent had full and complete knowledge of the rights of the surety company. Its own memoranda indicate that they regarded their rights as inferior to the surety, unless the surety subordinated (R. 36).

In *Raymond Concrete Pile* v. *Federation Bank*, 288 N. Y. 452, the Court held that if there is evidence that the bank knew or had reasonable grounds to know that subcontractors were unpaid the bank was in duty bound to regard the deposit as a trust fund. That the respondent knew subcontractors were unpaid was never questioned. The same trust principle is applicable to the receipt of moneys under a Federal contract.

> *California Bank* v. *U. S. F. & G.*, 129 F. (2d) 751; *Maryland Casualty* v. *Lincoln Bank*, 40 Fed. Supp. 472.

In the case at bar, it was the deposit of the Government check of $155,865.50 and the drawing of the bankrupt's check for $150,000 that created the simultaneous transaction resulting in the preference. There was never any thought of set-off.

In this connection, we wish to answer the respondent's argument that in adhering to the bank's records we are putting form above substance. That claim of the bank, although completely unfounded, is nothing new. It has been repeatedly raised by banking institutions, especially where they subsequently claim that they had the right to do by way of set-off what they did not have a right to do by reason of the transaction as it actually occurred. In answering a similar contention, this Court said in *Trader's Bank* v. *Campbell*, 81 U. S. 87 at 97:

> "They now claim that this was what they had a right to do and that it should remain a valid set-off. But this does not appear to have been really what was done."

Again, *In re National Lumber Co.* (C. C. A. 3d Cir.), 212 Fed. 928, the Court had special occasion to answer a similar argument, stating at page 929:

> "If the company had allowed the money to remain in its account until after bankruptcy had supervened, a situation would have been presented to which the clause (Sec. 68a) might have applied. But this was not done. The money was actually drawn out by the company—for this was the effect of its check—and was actually handed over to the bank in payment of the note, so that we do not have a case of mutual accounts

where one may be set off against the other, but the case of the use of money to pay a debt under circumstances that made the payment preferential. The argument really comes to this: If the payment had not been made, the bank could have set off the deposit against the note, and the result would then have been just what it is now. The sufficient answer is—the contingency did not happen. The parties chose to pay and to accept the money in the ordinary course of events, and their conduct is to be judged by what they did, not by what they might have done. Bank v. Campbell, 81 U. S. (14 Wall.) 87, 20 L. Ed. 832."

The Surety was a creditor within the meaning of Section 60a of the Bankruptcy Act whose rights enured to the Trustee in Bankruptcy.

At page 44 of respondent's brief, it urges that the authority of the trustee is not enlarged by reason of the fact that the bankruptcy is the individual venture of the surety company. We make no such claim. On the contrary, we urge the creditor and other status of the surety for two reasons:

(1) The surety being a potential creditor who could have intervened on November 27th and prevented the transfer of the Government funds to the bank, the trustee may assert that status in his own behalf.

(2) If the bank rests its claim to the Government check on the assignment *per se*, then it must fail because the surety company had a prior assignment which entitled it to the check both at law and in equity.

We had endeavored to avoid any discussion as to the motive of the surety's action in the bankruptcy proceedings

and hoped that the argument would be limited to the applicable legal principles. Respondent, however, ever mindful of the delicacy of its position as evidenced by its office memoranda now casts aspersions on the action of the surety in precipitating the bankruptcy proceedings and instigating this action. For that the surety has no apologies. After the bankrupt's contracts with the United States were completed, its financial affairs were in such a muddle that bankruptcy was the only alternative. Not only were large sums due from the government, but other funds and equipment were available which were being dissipated by the bankrupt. The proposed action against the respondent was but one motivating factor and far from the sole reason for bankruptcy. Whether the surety will be a general creditor or whether it will be able to impress a trust on the avails of the preference suit is foreign to this appeal. On that issue there is and will be considerable difference of opinion.

The respondent likewise realizing that the defaults did exist on November 27th and that the surety could have enforced its rights, now argues that the surety did nothing about it then as a reason for defeating this action. What would the respondent have the surety do at the time? The surety was indeed in a most awkward and embarrassing position. The bank had been fully paid. The surety company faced a host of unpaid creditors and an incompleted contract. The War Department was clamoring for its buildings.

The surety company certainly had nothing whatsoever to gain by precipitating bankruptcy at that stage. It was common sense to make the best of the condition at the time, finish and turn over the completed contract to the Government, pay the obligations to the creditors, and then determine the question of the bank's right to the $150,000 payment. If the bank were right, it lost nothing. In fact it

had continued to lend the Contractor large sums of money at profitable rates of interest on the best security existing—moneys due from the Government. Certainly there is nothing that can be the subject of criticism in the surety attempting to right a wrong after the Government was fully satisfied, and there was nothing left but to determine the legal rights of all concerned.

Respondent would also have this Court believe that the surety company at no time made any effort to protest the assignment, and voluntarily and without suggestion on the part of the bank executed the letter of December 6th (R. 37-38). Nothing could be further from the fact. Protest it did, for that is evident by the very letter of December 6th. The Bank had already obtained the $155,865.50 and threatened, according to its own memoranda, to cease financing. Knowing full well of the surety company's rights, it took great pains to demand the letter of December 6th before advancing any further funds, for it feared the surety, even though the assignment was then filed. The fact that the job went sour by over $300,000 is eloquent testimony to the benefits the bank derived by its skillful maneuvers, for it was the surety company that sustained the entire loss. Yet, the Bank now has the temerity to suggest that the surety was guilty of some improper conduct in causing a petition in bankruptcy to be filed. It would have this Court believe the ridiculous yarn that the surety in some manner deceived the Bank into making continued loans, only to strike surreptitiously through the trustee in bankruptcy.

As we see it, the respondent acted on the theory that possession was nine-tenths of the law, and that it was good business policy to grab all the money it could and risk later litigation. It should not now attempt to conceal that obvious course of conduct by casting aspersions on the

motives of those who attempt to undo its alleged illegal action.

Respectfully submitted,

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